EXHIBIT 5
DATE 02/07/13

Legislative Fiscal Division

http://leg.mt.gov/css/fiscal

Report by Terry Johnson FY 2011

DEPARTMENT OF REVENUE AUDIT REVENUE ISSUE

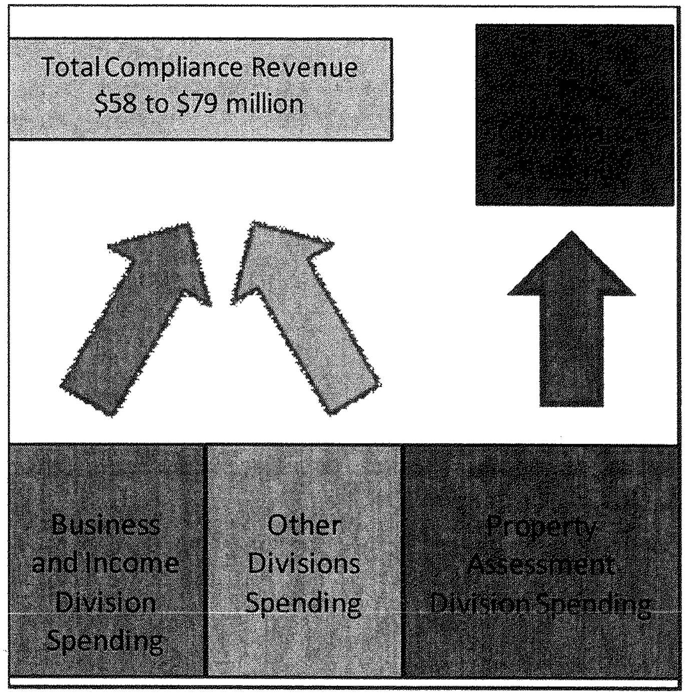
The following table shows the actual audit collections tallied by the Department of Revenue (DOR) for fiscal year 2007 through 2010. The table summarizes the data by tax type. As shown in the table, individual and corporation income taxes account for a majority of the audit activity. The lone exception was in fiscal 2010 when the department received $15.6 million in collections from a federal royalty audit.

It should be noted that the Legislative Fiscal Division (LFD) did not analyze the procedures used by the department to determine what constitutes an audit collection. The LFD attempted to retrieve the data from the state accounting system but found that not all the information was adequately tagged on the system. Therefore, the information shown below is as prepared by the department.

Tax Type	Fiscal Year 2007 Audit Collections	Fiscal Year 2008 Audit Collections	Fiscal Year 2009 Audit Collections	Fiscal Year 2010 Audit Collections
Individual Income Tax	$25,453,334	$29,264,487	$35,267,961	$37,243,709
Withholding	3,148,291	3,372,288	4,003,590	4,565,375
Corporation License Tax	26,812,700	16,873,022	31,036,393	15,380,337
Miscellaneous Taxes				
Retail Telecommunications	696,505	1,223,832	344,926	2,402,196
Abandoned Property	-	-	51,529	327,683
Cigarette & Other Tobacco Products	413,617	321,638	293,360	96,836
Rental Vehicle	14,400	11,602	10,730	16,158
Lodging Facilities	581,000	603,310	754,131	1,150,023
Public Service Regulation, Consumer Counsel Tax, 911, TDD, Nursing Facilities Bed Tax	108,382	136,335	176,567	486,674
Contractor's Gross Receipts		-	384,061	-
Beer, Wine, Hard Cider	5,660	25,111	446	-
Electrical Energy	-	-	-	429
Industrial/Centrally Assessed	-	-	-	100,084
Natural Resources Taxes				
Oil and Gas Production	1,238,279	4,985,367	2,431,136	1,395,008
Coal Severance Tax	-	68,821	2,162,528	177,254
Metal Mines Net Proceeds	-	275	53	56
Bentonite	-	538	253	2,223
Metal Mines Gross Proceeds	-	75	-	154,176
Metal Mines License Tax	-	14,820	-	176
Resource Indemnity Trust Tax	-	1,454	160,631	1,090
Federal Royalty Audit	-	723,088	422,767	15,584,917
Other	492,517	-	-	-
Total	**$58,964,685**	**$57,626,063**	**$77,501,062**	**$79,084,404**

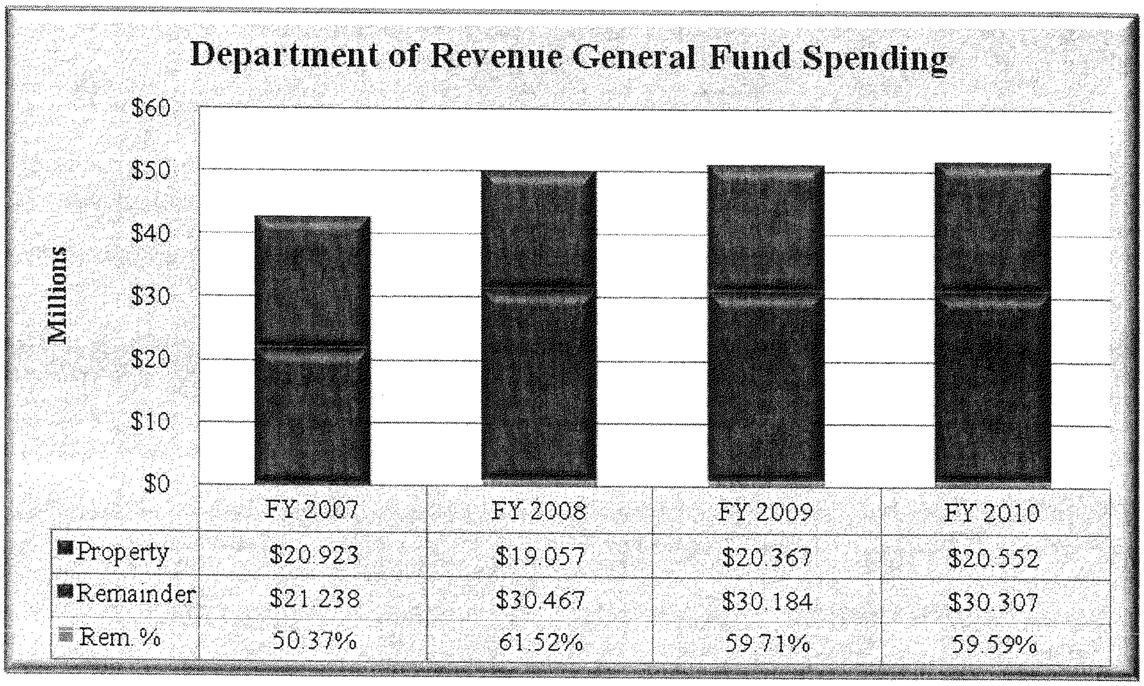
Source: Department of Revenue; Summary of total audit collections by tax type.

The department has provided illustrations on the overall return on investment they have experienced with its compliance efforts. The department computes a ratio based on audit revenues divided by the amount appropriated to the business and income division only. As the graphic below shows, the LFD contends that all divisions except for the property assessment division should be included in this calculation.



The remainder of this document provides the detail behind the computed ratios and shows the information graphically when appropriate. There are questions provided throughout the document to assist legislators in formulating a decision making process.

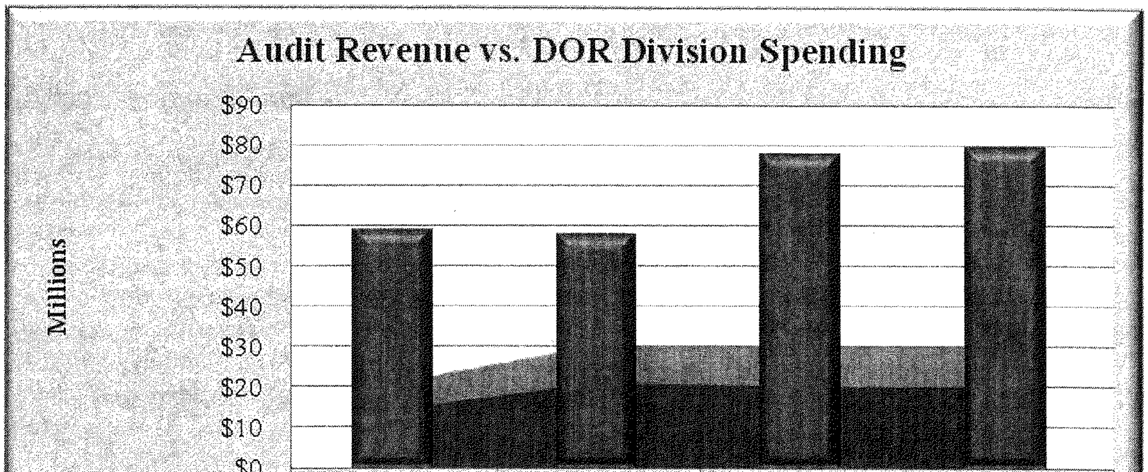
The following chart shows total Department of Revenue general fund spending by fiscal year. As shown in the chart, approximately forty percent of their spending is for the property assessment division while the remainder (about 60%) is for the remaining divisions.



	FY 2007	FY 2008	FY 2009	FY 2010
Property	$20.923	$19.057	$20.367	$20.552
Remainder	$21.238	$30.467	$30.184	$30.307
Rem. %	50.37%	61.52%	59.71%	59.59%

Question: Does spending in the property assessment division contribute to the overall audit effort of the department?

Since the property tax assessment division is responsible for the administration of property assessments and taxes, it does not seem appropriate to include this spending as a contributor to audit collections. It should be noted, however, that a reduction in funding for this division may reduce property tax revenue collections at both the state and local levels.



	FY 2007	FY 2008	FY 2009	FY 2010
Business & Income	$6.679	$9.116	$9.823	$10.082
Other Divisions	$14.559	$21.351	$20.361	$20.225
Audit Revenue	$58.965	$57.626	$77.501	$79.084

01 Director's Office
02 Information Technology & Processing Division
05 Citizen Services & Resource Management Division

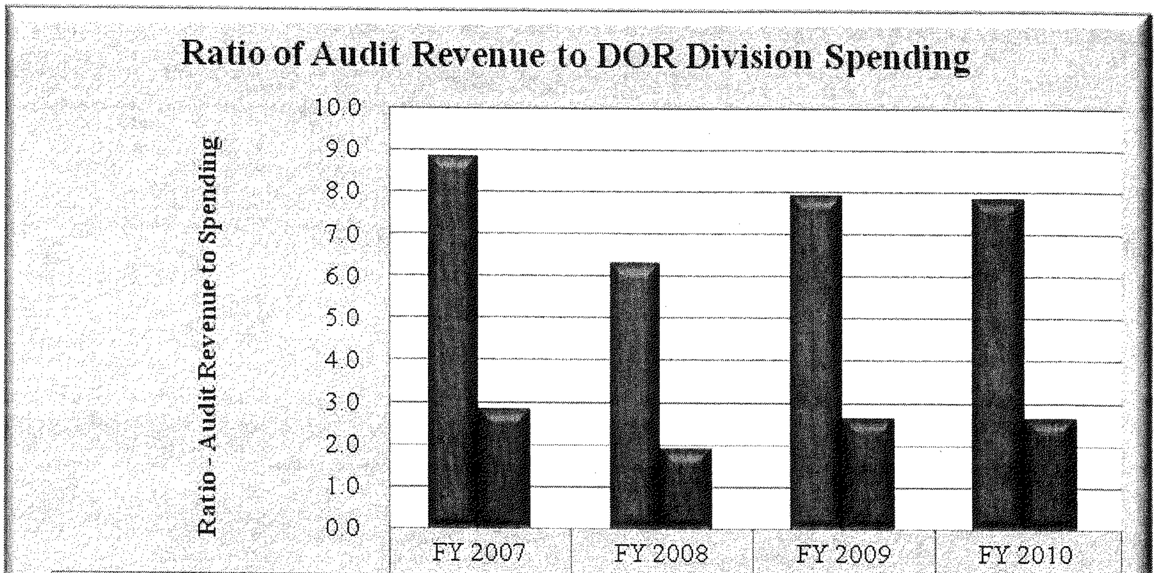
The above chart depicts the amount of audit revenue received by fiscal year – fiscal 2007 through 2010. It also shows the general fund spending amounts in the Business & Income Tax Division and the other divisions. The other divisions included are listed below the chart. As portrayed in the chart, total spending for these divisions increased by over $9 million from fiscal 2007 to 2008 while audit revenues actually declined by over $1 million. Spending for these three divisions have remained relative stable since fiscal 2008 (about $30 million). Audit revenues, however, have increased by about $20 million in fiscal 2009 and 2010 from the amount received in fiscal 2008.

Question: Does approximately $30 million in division spending produce $57 million (fiscal 2008) or $77 plus million (fiscal 2009) in audit revenues?

The answer to this question could have a significant impact on future audit revenues. In other words, using data from fiscal 2008 would produce an audit to spending ratio of about 1.9 – for every dollar expended produces about $1.90 in audit revenue. Using the data for fiscal 2009 or 2010 would produce a ratio of about 2.6. Both of these calculations are based on the total spending in these divisions.

	Audit Rev.	*Personal*	*Operations*
Audit Rev.	100.00%		
Personal	89.92%	100.00%	
Operations	14.82%	54.29%	100.00%

The table to the right shows a correlation matrix between audit revenue and spending for personal services and operation costs. As the table shows, audit revenue is highly correlated with personal services spending while operational costs do not have much of a relationship. Although this statistical technique can be misleading, it does indicate that audit revenue is highly dependent on the level of funding for personal services. This matrix was based on data for all divisions except the property assessment division from fiscal 2007 through 2010..



	FY 2007	FY 2008	FY 2009	FY 2010
Business & Income Division	8.8	6.3	7.9	7.8
All Divisions less Property	2.8	1.9	2.6	2.6

The above chart shows the ratio of audit revenue to spending in DOR division categories. As shown in the chart, the ratio is higher if you use a smaller number in the denominator – business & income division versus all the divisions less the property assessment division. The department computes the ratio based on audit revenues divided by the spending in the business & income division only. Therefore, the department argues that if the legislature reduces their budget, each dollar in reduction will reduce revenues by approximately $8. This argument implies that the reduction would be taken in the business & income division only because their calculated ratio is based on this division only. The LFD calculates the ratio based on audit revenues divided by the spending in all divisions less the property assessment division. The calculation results in a ratio of about 2.6, considerably less than the department's ratio. The justification for this approach is that all of these selected divisions contribute to the audit effort. The director's office as well as the information technology division all plays a role in producing the audit revenue. Even the department argues you have to look at the department as a single cohesive function because it is so interrelated.

Question: If the department is a single integrated function, why should the audit ratio be calculated based on spending in one division only?

As discussed on page 1, the spending for the property assessment division should not be included in the audit to spending ratio. An argument can also be made that a portion of the spending in the other divisions exclusive of the business and income tax division are used to support the property assessment division. The director's office as well as the information technology division assists the property assessment division in accomplishing their mission. If you assume the property assessment division utilizes 40 percent of the other divisions' services, then the audit to spending ratio increases from 2.6 to about 3.5.

Question: Should a portion of the other divisions spending for the property assessment division be deducted before the audit to spending ratio is calculated?

LFD Recommendations

Option 1

As the state and national economies recover from the "Great Recession", many businesses are struggling to get back on strong financial footing. It is becoming clear that one of their strategies is to forego hiring as long as possible to make sure that the signs of recovery are real. In order for businesses to expand but yet be cautious about hiring, they have tried to increase productivity with existing employees and infrastructure. The legislature may want to consider asking the department to outline a number of options that would increase productivity within the department but yet reduce costs.

Option 2

- ✓ Assume the audit collection categorization by the department is correct
- ✓ Exclude the property assessment division in calculating the audit to spending ratio
- ✓ Assume fiscal 2009 and 2010 as representative years for audit revenue and spending by divisions
- ✓ Assume that all divisions except the property assessment division contribute to the total audit effort
- ✓ Deduct a portion of the other divisions spending for the property assessment division in calculating the audit to spending ratio – request this information from the department
- ✓ Calculate the ratio based on the above assumptions and show the impact in the general fund status sheet if necessary

Option 3

Take no action and assume that potential reductions in the department's budget will have no impact on revenue collections.